BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

In the Matter of the Application)	
HAWAIIAN ELECTRIC COMPANY, INC.)	**Docket No. 2008-0083**
For Approval of Rate Increases and)	
Revised Rate Schedules and Rules)	
)	

OPENING BRIEF OF THE DEPARTMENT OF DEFENSE

AND

CERTIFICATE OF SERVICE

January 5, 2010

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OPENING BRIEF OF THE DEPARTMENT OF DEFENSE

COMES NOW, DEPARTMENT OF DEFENSE by and through its undersigned attorney and hereby submits the Opening Brief of the Department of Defense to the Public Utilities Commission of Hawaii.

DATED: January 5, 2010, Honolulu, Hawaii

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I. INTRODUCTION

On July 3, 2008, HECO filed an application for approval of rate increases in which HECO requested a general rate increase of approximately $97.011 million over revenues at current effective rates.[1] The Commission granted DOD intervention on August 20, 2008. On April 17, 2009, DOD filed three sets of testimonies and exhibits regarding revenue requirement, cost of capital, and cost of service/cost allocation/rate design issues. DOD's recommended revenue requirement increase of $42.1 million reflects DOD's position on cost of capital as well as a number of adjustments to HECO's proposed rate base and net operating income. On May 15, 2009, HECO, the Consumer Advocate, and DOD filed a Settlement Agreement on most issues, reserving two issues for litigation: (1) advertising expense and (2) return on equity. The Settlement provided for an interim revenue increase of $79.82 million. On May 18, 2009, HECO claimed an amount of $79.811 million as its Probable Entitlement. On July 2, 2009, the Commission issued its Interim Decision and Order that ordered HECO to remove certain items from the amount of Probable Entitlement. On July 8, 2009, HECO filed revised calculations in support of a Probable Entitlement amount of $61.1 million interim rate increase, representing a reduction of approximately $18.7 million from the $79.8 million interim increase that HECO had previously proposed. On July 20, 2009, DOD filed supplemental testimony stating that DOD views the Settlement Agreement as an integrated package that was negotiated by the parties for the comprehensive and balanced resolution of the issues addressed therein. A panel hearing was held on October 26, 2009

[1] See, e.g., Interim Decision and Order, page 2.

through November 6, 2009. As discussed in detail below, the only issue remaining addressed by the DOD is the allowed rate of return.

II. COST OF CAPITAL

In order to determine a reasonable return on equity in this proceeding, three primary issues should be evaluated:

First, the current cost of equity capital for electric utilities similar in risk to HECO needs to be determined. That cost of equity capital will be applied to the portion of HECO's rate base that is supported by equity capital (54% in the Company's requested and uncontested capital structure) and will provide the annual profit the Company is afforded the opportunity to earn. As DOD witness Hill explains (DOD T-2, page 4), the range of single-point equity return recommendations before the Commission in this proceeding 9.5% (DOD) to 11.0% (HECO—without HCEI adjustment clauses) allow for an annual profit for HECO ranging from $67 Million to $77.6 Million.[2] Of course, ratepayers have to provide sufficient revenues to enable the Company pay taxes on that range of profit, so the impact on ratepayers would be $108 Million to $125 Million ($77.6 Million/(1-38% tax rate), a difference of approximately $17 Million annually.

The second issue is the magnitude of the reduction in ROE due to the lower operating risk imparted by the adjustment mechanisms included in the HCEI initiative—the most important of which are decoupling rates from sales, allowing rate base additions between rate cases and pass-through of all purchased power expenses outside of rate case

[2] $1.3 Billion rate base x 54.3% Equity Ratio x 11.0% HECO ROE = $77.6 Million. This is the same formula used by DOD witness Hill, substituting HECO's most recent ROE recommendation.

review. (Tr. 1307-1310, Parcell)[3] All parties agree that the HCEI adjustment mechanisms will lower risks for HECO, which, in the past, has been considered an above-average risk electric utility, to one that has below average risk. The range of equity return reduction recommended to the Commission in this proceeding is 25 to 50 basis points.

The third issue was raised by the Commission during the hearing. The Commission is faced with the unenviable task of parsing the recommended equity return reductions if it elects not to include all of the adjustment mechanisms, as evidenced at the hearing in the colloquy between Commissioner Kondo and the cost of capital witnesses. Unfortunately, this issue was not addressed by the cost of capital witnesses in this proceeding.

The only quantification concept provided in the hearing was by Consumer Advocate witness Parcell, who discussed rationing a 50 basis point decrement based on the revenue impact of each major risk-reducing elements of decoupling, renewable energy initiative surcharge (REIS), and purchased power adjustment clause (PPAC). (Tr. 1307-1310) While that approach has rational appeal, it is not at all clear how the "impact" measurement would be made and over what period it would be analyzed—making any assessment of the suggested methodology difficult. Based on the evidence provided by DOD witness Hill a 50 basis point decrement for a decoupling, alone, is reasonable.

As this Commission is aware, HECO's revenues are very sensitive to the condition of the local economy. A sluggish economy negatively impacts Hawaii's

[3] There are other aspects of the HCEI "package" that will also reduce operating risk to some degree, e.g., adding automatic trackers for taxes and continuing a tracker for pension fund costs, but those have a smaller impact on operating costs, and therefore investment risks, than the primary adjustment mechanisms.

important tourism industry and typically results in reduced sales for HECO. Under a decoupling regime, the Company will recover its test-year revenues independent from its sales. Therefore, if decoupling were now in place, HECO would be unaffected by the current economic downturn, and for that reason, would be significantly less risky.

With regard to the other two primary risk-reducing aspects of the HCEI (REIS and PPAC), both of those mechanisms represent a change in the timing of the receipt of revenues, but not the amount as with decoupling. For example, all prudently-incurred purchased power costs and plant addition costs that will be recovered automatically under these mechanisms are also recovered under the current regulatory regime. However, they are currently recovered through the process of a rate case, not an automatic adjustment to rates. While it is certainly true that allowing recovery of such costs sooner and with more certainty would reduce operating risks, it is not clear that those risk differences would be as substantial as that offered by decoupling.

Therefore, in an effort to assist the Commission in parsing a 50 basis point reduction to the cost of equity capital for HECO, DOD recommends the application of the full 50 basis points if the entire HCEI "package" is adopted and the same 50 basis point reduction if the only regulatory mechanism adopted is revenue decoupling. If only the REIS and PPAC are adopted and decoupling is not, an equity return reduction of no less than 25 basis points is recommended.

A. The Current Cost Of Equity Capital

All the cost of equity capital analyses use market data to estimate the return investors expect to earn on common stock over the long term. HECO has substantial

long-term equity investments in its pension fund.[4] The Company's expected long-term return on its own equity investments, provided in response to DOD-IR-11, is just below the low-end of DOD witness Hill's cost of equity range in this proceeding. That means the return HECO expects to earn on its own equity investments is below all of the equity capital cost estimates provided by the witnesses in this proceeding (even with the inclusion of a decrement for risk-reducing adjustments that may be implemented). Therefore, with the perspective of the Company's own expectations for long-term returns on common equity capital, the DOD submits that its recommendation for the equity cost of HECO, 9.50%, is somewhat conservative, but the unadjusted recommendations of the Consumer Advocate (10.0%) and HECO (11.0%) are likely to overstate the current cost of capital.

B. Equity Cost Estimates

The equity return recommendations of DOD and HECO in this proceeding would not be widely dispersed, if the methodologies originally used by the Company witness, Dr. Morin, had been consistent with the ones used in his Rebuttal and updated testimonies. As discussed by DOD witness Hill in his Direct Testimony (DOD T-2), if the cost of equity methods used by Dr. Morin in his direct testimony were updated using the market data that were current in the first quarter of 2009, Dr. Morin's results would have confirmed the reasonableness of Mr. Hill's 9.5% equity return recommendation.

As Mr. Hill points out if Dr. Morin performed his CAPM and ECAPM analyses using his original sample group of companies, in early 2009, his results would have been 8.61% and 9.18%, respectively. [DOD T-2, pp. 58 and 62] If Dr. Morin had replicated

[4] According to the 2008 Annual Report, HEI's pension fund portfolio was approximately $1 Billion and 70% of that total was equity. (DOD T-2, p. 51)

the Risk Premium analyses used in his Direct Testimony, his results would have been 9.1% for his historical risk premium and 9.2% for his allowed return risk premium. [DOD T-2, p. 62] However, when Dr. Morin filed his rebuttal a few months later, he did not replicate the risk premium methodologies used in his Direct Testimony and changed the results.

In his Rebuttal Testimony (HECO RT-19), Dr. Morin changed the bond yield basis of his historical risk premium analysis from long-term Treasury bonds to utility bonds, which carried yields significantly higher than long-term Treasury bonds. (Tr. 1020). In response to DOD RIR-62(c), when asked to provide copies of all testimonies submitted by Dr. Morin in the five years prior to 2009 in which he used utility bonds instead of Treasury bonds as the basis for his historical risk premium analysis, he provided no such testimonies. The historical risk premium result reported in Dr. Morin's Rebuttal Testimony (HECO RT-19, p. 73) was 11.2%. If he had performed that analysis in the same manner as he has for many years, (using long-term Treasury bond yields as the basis), his result would have been 9.7%. (Tr. 1017, ll. 14-17) Therefore, Dr. Morin's change in methodology increased the result of his historical risk premium analysis in his Rebuttal Testimony by 150 basis points.

Dr. Morin also changed the group of utilities on which he performed his historical risk premium analysis. His rationale for that change, set out at page 70, lines 13 through 16, of HECO RT-19, is that Moody's ceased publication of its electric utility index in 2002, therefore he chose to rely on S&P's utility index instead.[5] Of course, that condition

[5] In the hearing (Tr. 1016, ll. 6-13), Dr. Morin seems to indicate that his change from Moody's electric utility index to S&P's utility index was due to the fact that Moody's ceased to publish its index following the time when he submitted his Direct Testimony.

(Moody's cessation of the publication of its electric utility index) existed when Dr. Morin performed the historical risk premium analysis in his Direct Testimony, but he does not provide an explanation as to why the use of that index (discontinued in 2002) was acceptable in 2008, but not 2009. Similarly, in shifting from Treasury bond yields to utility yields, Dr. Morin simply states that because the yield differential between utility bonds and Treasury bonds was temporarily inflated by the financial crisis in 2008, Treasury bond yields were "no longer appropriate." (HECO RT-19, p. 70, ll. 18-20) He offers no theoretical reason why Treasury bond yields are rendered unusable when they diverge from utility yields, or why they were appropriate for many years prior to his Rebuttal Testimony. We can only assume that Dr. Morin's change of methodology was result oriented.

Another aspect of Dr. Morin's Rebuttal Testimony that is different from his Direct, and appears to be result-oriented, is his elimination of "Allowed Return Risk Premium." That method examined the 10-year historical difference between equity return allowanced by utility commissions (published in Regulatory Research Associates—RRA) and the then-current Treasury bond yield. In his Direct Testimony Dr. Morin determined that historical allowed return yield differential to be 5.6%. If that yield differential had been added to the Treasury bond yield extant at the time of his Rebuttal (4%), the result of Dr. Morin's Allowed Return Risk Premium would have been 9.6%. (Tr. 1021).

Dr. Morin elected not to include that analysis in his Rebuttal Testimony—he just left it out—and raised his average equity cost estimate by doing so. In his Rebuttal, Dr.

We assume that testimony was an oversight by Dr. Morin, as he clearly indicates in his Direct Testimony that Moody's ceased publication of its electric utility index in 2002.

Morin used "scarcity of [ROE] decisions since the financial crisis began," for leaving that analysis out and repeated that rationale at the hearing. (Tr. 1022, ll. 1-4) However, that is not correct. RRA reports there were 37 ROE cases decided in 2008, the year in which Dr. Morin claims a "scarcity" of decisions. RRA also reports that in 2007 and 2006 there were 39 and 26 decisions, respectively. (Tr. 1023, ll. 11-15) However, in his Direct Testimony, Dr. Morin utilized the RRA data for 2006 and 2007 without any expressed concern about the scarcity of rate decisions.

Again, we are forced to conclude that Dr. Morin's decision to omit in his Rebuttal Testimony an analysis he had used to estimate the cost of equity in his Direct is not based on sound logic but is, in fact, result-oriented. In a data request in a separate but current rate proceeding Dr. Morin was asked why methodological consistency was important in cost of capital analysis. His response was: "Methodological consistency is important for reasons of professional credibility and robustness to varying economic circumstances."[6]

If Dr. Morin had been consistent in the application of his Risk Premium methods, his average equity cost estimate provided in his Rebuttal and his Update, absent an unnecessary 30 basis point adjustment for flotation costs,[7] would have ranged from 10.23% to 10.06%, as shown in the table below.[8] That is, had HECO's cost of capital witness performed his cost of capital analyses as he did in his Direct Testimony, his results would have appeared as they do in the table below (absent flotation costs).

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[6] Washington Utilities and Transportation Commission Docket Nos. UE-090704 and UG-090705, Puget Sound Energy, Public Counsel Data Request No. 162.
[7] See DOD T-2, pp. 45-47.
[8] The Treasury bond rate at the time of Dr. Morin's Rebuttal was 4.0% and the Treasury bond rate at the time of his update was 4.3%. Dr. Morin's "Zack's" earnings growth DCF and "Value Line" earnings growth DCF for each of his sample groups are averaged so that all methods CAPM, Risk Premium and DCF have equal weights.

TABLE I.

METHODOLOGICALLY CONSISTENT MORIN ROE ESTIMATES

Methodology	Rebuttal ROE	Update ROE
CAPM	8.90%	9.10%
Empirical-CAPM	9.30%	9.50%
Historical Risk Premium	9.70%	10.00%
Allowed Return Risk Prem.	9.60%	9.90%
DCF-similar sample	12.15%	10.85%
DCF-S&P utilities	11.70%	11.00%
Average	10.23%	10.06%

Even adding back the unnecessary 30 basis point flotation cost would produce a range of 10.53% to 10.36% for Dr. Morin's sample group of companies—well below the 10.75% to 11.0% range he recommends with his newly-altered cost of equity estimation methodology.

Therefore, the reliable range of equity cost estimates before the Commission in this proceeding is 9.25% (the low end of DOD witness Hill's range) to 10.50% (the upper end of CA witness Parcell's range). If Dr. Morin had applied his cost of equity analyses in a consistent manner, his most recently updated cost of equity estimate would have

averaged 10.06% without flotation costs and 10.36% with them. Both averages are below the upper end of Mr. Parcell's equity cost estimate.

With regard to equity cost recommendations, the reliable range is narrower. Mr. Hill recommends an allowed return on equity of 9.5%, while, absent any risk-reducing regulatory mechanisms, Mr. Parcell would recommend the mid-point of his range, 10.0% as a point-estimate of HECO's cost of equity capital. (Tr. 1262, ll. 1-2)

In the hearing Commissioner Kondo asked what an allowed return of 9.5% would do to HECO's financial status. (Tr. 1298, l. 23 -1299, l. 2) DOD witness Hill has already answered that question. He notes, at page 53 of DOD T-2 that the 9.5% return on equity, operating through the Company's requested capital structure would produce a pre-tax interest coverage of 4.71 times. Moreover, that coverage ratio is substantially in excess of the historical interest coverage ratio exhibited by HECO, which has averaged just 3.15 times over the past few years (HECO 2008 S.E.C. Form 10-K (Exhibit 12)). Therefore, that allowed return affords the Company the opportunity to achieve higher financial metrics that it has in the past, and would support the Company's credit and financial position.

C. Capital Structure And Purchased Power

As Commissioner Kondo recognized in the hearing (Tr. 1206) there is a relationship between the financial risk of a firm and its cost of equity capital. The more common equity (less debt) used in financing the firm's assets, the lower the financial risk and the lower the required return on equity. As DOD witness Hill points out in DOD T-2, pp. 17, 18, the average common equity ratio in the electric utility industry is 44% of total capital, the average common equity ratio of Mr. Hill's sample group of companies is

43% and the average common equity ratio of Dr. Morin's sample group is 44%. HECO's ratemaking capital structure (which is uncontested in this proceeding) contains 54.3% common equity—substantially more than the market-traded utility holding companies that were used to estimate the cost of equity in this proceeding.

At page 1145 of the hearing Transcript VII, under questioning by Commissioner Kondo, Dr. Morin opined that HECO's relative financial risk would be altered (its common equity ratio effectively lowered) by the debt equivalents assigned to it by bond rating agencies due to the Company's purchased power commitments. Left unsaid was the fact that the same would be true for the electric utility industry. That is the 43%-44% average common equity ratio of the electric utility industry would be lowered if the purchased power obligations were accounted for in the same manner. In other words, an apples-to-apples comparison of HECO and electric utility industry purchased-power-adjusted capital structures was not undertaken.

Mr. Hill addressed this issue with regard to his similar-risk sample group of electric companies, at pages 17 through 19 of DOD T-2, and showed that his sample group had similar levels of purchased power expense, in addition to similar business risk rankings and bond ratings. While Dr. Morin did not provide a comparison of HECO's purchased power expenses to those of his sample group in his Direct or Rebuttal testimonies, in response to DOD-IR-31, he did. That response indicates that, for the twelve integrated electric utilities in his sample group for which data are available, the average percent of purchased power is 15%—about half of that of HECO. However, there are six transmission and distribution utilities in Dr. Morin's sample group—utilities that purchase 100% of their power—which are left out of his calculation. Including those

utilities indicates that his sample group's purchased power represents 43% of total power supply (greater than that of HECO). Dr. Morin also states in response to DOD-IR-31(b), regarding the evaluation of purchased power risk:

> Dr. Morin also notes that the financial risk due to the presence of off-balance liabilities such as purchased power contracts is already reflected in traditional measures of risk for HEI and for Dr. Morin's comparable-risk companies, such as beta and bond rating.

Therefore, selecting sample groups that are similar in bond rating, business risk and beta coefficient (a method used by all cost of capital witnesses in this proceeding), includes consideration of any relative differences in purchased power risks.

In summary, any difference between HECO's operational risks related to purchased power are accounted for in the similar-risk sample group selection process, therefore, financial risk differences exhibited by substantial differences in capital structure should be addressed in the determination of the equity return to be allowed for regulatory purposes. As noted, the average common equity ratio of the sample group of electric utilities used by HECO and DOD, is about 44%—the same as the industry average. HECO's rates are to be set with a common equity ratio more that ten percentage points higher. According to Dr. Morin's calculus, that difference in common equity ratio would call for a 100 basis point adjustment to the allowed return on equity for HECO. (Tr. 1146) DOD's recommendation is much more conservative—25 basis points—to recognize the lower financial risk afforded HECO by the use of a capital structure with a common equity ratio substantially greater than the sample companies used to estimate the cost of equity capital. (DOD T-2, p. 50)

D. The Appropriate Equity Return Decrement

In order to recognize the reduction in operating and investment risk afforded by the HCEI initiatives, Dr. Morin recommended the Commission utilize the bottom end of his range, 10.25%, which represents a 25 basis point decrement from what he believes to be the current equity capital cost of otherwise similar-risk electric companies. During cross-examination, Dr. Morin confirmed that all of the HCEI adjustment mechanisms identified in the testimony of DOD witness Hill reduced HECO's investment risk, (Tr. 1210-1211) and indicated those mechanisms would move HECO from a riskier-than-average company to one that has less risk than average:

> Chairman Caliboso: You were saying earlier that HECO is a little bit more risky than other utilities.
> Mr. Morin: Well, not if you approve all of these mechanisms, that will make it less of a risk. [Tr.1051, ll. 10-13]

Consumer Advocate witness Parcell also recognizes the fact that, as a result of the adjustment clauses included in HECI, HECO will become a much less risky operation. As a result, Mr. Parcell recommends an allowed return on common equity for HECO of 9.5%, which represents a 50 basis point decrement from what he believes to be the current equity capital cost of otherwise similar-risk electric utilities.[9]

DOD witness Hill, in Exhibit DOD-201, provides the Commission an example of a prior estimate of the cost of equity impact he has undertaken that shows an appropriate,

[9] Mr. Parcell estimates the current cost of equity capital of electric utilities similar in risk to HECO to be in the range of 9.5% to 10.5%, and we assume here that an "average risk" utility would have an equity cost at the mid-point of that range, 10.0%. Therefore, his recommendation of a 9.5% return for HECO represents a 50 basis point reduction from an otherwise similar-risk electric utility.

if not conservative, reduction in allowed equity return to be 50 basis points.[10] Although Mr. Hill does not attempt to quantify the allowed equity return decrement that is appropriate in this proceeding he urges this Commission to view a post-HCEI HECO as less risky than other utilities, on average:

> However, rather than attempt to project any precise "basis point" impact of HCEI, I believe its risk-reducing aspects can be appropriately recognized by this Commission shifting its view of HECO as an above-average risk utility to one that, with HCEI, has lower-than-average risk. As such, after the Commission determines a reasonable range for the cost of equity for HECO, it would be appropriate to utilize the lower portion of that range when awarding an allowed return. In allowing HECO a lower level of profit that it would have absent HCEI, the Commission would fulfill its obligation to provide the Company a reasonable opportunity to earn an appropriate risk-adjusted return, while providing Hawaii ratepayers some of the benefits arising from the lower operating risks afforded HECO by the public/private partnership newly codified in the HCEI agreement. [DOD T-2, p. 8, ll. 20-29]

Therefore, the range of equity return reductions before the Commission in this proceeding is 25 to 50 basis points. Using the same formula used by Mr. Hill to calculate the rate impact of the allowed return, shows that an equity return reduction of 25 to 50 basis points will save HECO's customers from $2.8 Million to $5.7 Million annually. [$1.3 Billion rate base x 54.3% Common equity ratio x (0.25% to 0.50%) Equity return decrement ÷ (1-38% tax rate)]

The HCEI initiative will be expensive for the Company and, via the new automatic adjustment mechanisms included in HCEI, those additional costs will be

[10] Dr. Morin confirmed that Mr. Hill's analysis was sound, but stale. However a current analysis of decoupling produced the same result—a 50 basis point decrement. (Tr.1215-1220)

passed directly to ratepayers. In that way, the adjustment mechanisms will shift operational risk from HECO shareholders onto its ratepayers. (Tr. 1081) In order to compensate consumers and allow them to enjoy some of the reduced risk realized by the utility, all parties in this proceeding agree that it is appropriate to reduce the costs incurred by consumers by lowering the profit the utility is allowed to earn.

Given the huge costs to be experienced by HECO (and passed quickly on to consumers), which Dr. Morin estimates to be $1.8 Billion (Tr. 1004), DOD's position is that the maximum 50 basis point decrement should be applied. According to Mr. Hill's testimony 50 basis points is a conservative adjustment for decoupling alone. Moreover, a "discount" of $5.7 Million annually afforded by a 50 basis point reduction in ROE provides only a relatively small benefit to ratepayers in light of the costs they will eventually be required to pay to both fund and operate the additional $1.8 Billion of future HECO plant investment.

III. RECOMMENDATION

DOD recommended the equity cost of the Company's utility operations to be 9.5%, which is the mid-point of a reasonable range of equity costs for otherwise similar-risk electric utilities, due to the Company's relatively low financial risk as well as the new regulatory paradigm to be implemented in Hawaii.

CERTIFICATE OF SERVICE

I hereby certify that one copy of the foregoing document was duly served upon the following parties, by U.S. mail, postage prepaid, and properly addressed pursuant to HAR sec. 6-61-21(d).

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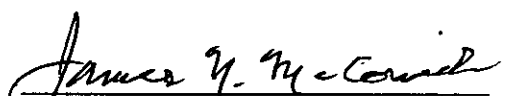

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